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SUBJECT: BAGHDAD'S ECONOMIC TRANSITION

Classified By: Deputy Political Counselor Greg D'Elia, for Reasons 1.4
(b) and (d).

11. (U) This is a Baghdad PRT reporting cable.

12. (C) SUMMARY: Reforms to educational institutions, the banking system, the civil service, state-market relations, and inter-governmental coordination has the potential to contribute significantly to private sector development in Baghdad province and hasten Iraq's transition to a mature market economy. These reforms may also lure more businesses into the formal sector; currently, the lack of a strong formal economy both reflects and compounds the Government of Iraq's (GoI) poor delivery of essential services and its inability to facilitate sustainable economic development in Baghdad. Doing business in Baghdad remains expensive and risky because the city's residents have limited access to credit, commercial insurance, and legal protections. Private and state-owned banks in Baghdad suffer from an uncertain security situation, scarcity of adequate capital markets, shortage of demand for value-added services, lack of access to technology, and a long history of low standards of transparency and accountability. As the GoI begins to implement reforms, militia activities and government corruption continue to stifle progress. For the Iraqi government to help spur economic growth, unprecedented agreement and coordination among the major ministries must occur on all fronts: security, services, rule of law, infrastructure, investment, and education. Where government officials have forged effective partnerships with Iraqi Security Forces and the private sector, they have facilitated the revival of commercial centers and traditional markets in Baghdad. In another notable development, business owners report that rental rates are rising significantly and now represent an even higher expense in Baghdad's cash economy. End summary.

There is an Economy, but What Kind?

13. (U) The lack of a formal economy in Baghdad both reflects and compounds the government's poor performance in providing the security, services, and infrastructure necessary to facilitate sustainable economic reconstruction and development. A formal economy, in which businessmen pay the government (through taxes and fees) to provide public goods (such as security, law enforcement, and electricity) exists in Baghdad, but many locals ignore or bypass it in favor of the informal sector, where they do not engage with, support, or benefit from government-regulated institutions, such as banks. Tens of thousands of businesses appear to be operating in spaces as large as modern office buildings and as small as kiosks, according to members of the Baghdad Chamber of Commerce and Iraqi-American Chamber of Commerce. PRToffs have observed an increase in business activity during trips throughout the city and meetings with local contacts. It remains unclear, however, how many of these businesses have licenses or pay taxes. As long as the government

largely fails to deliver essential public services and to punish tax evasion, citizens in Baghdad will continue to lack an adequate incentive to participate in the formal economy.

Doing Business in Baghdad is Expensive and Risky

¶4. (SBU) In Baghdad, like other areas in Iraq facing uncertainty and semi-permissive environments, the cost of doing business is expensive. To navigate Baghdad's complex and shifting market environment, business owners in Baghdad must employ entrepreneurial acumen. Business owners and investors face the potential for significant loss from corruption, theft or breach of contract because they cannot rely on legal institutions to protect their interests, and most do not have access to commercial insurance. The vast majority of residents must pay cash to start a business in Baghdad because they have limited access to loans or other financial instruments. With enough U.S. dollars, residents can purchase the goods and services that the government does not provide equally to all the city's residents, including security, permits, licenses, electricity (through generators), transportation, office equipment, and even government and private contracts. Among the important business expenses in Baghdad's cash economy, rent is the most significant rising cost, as reported by several business owners and NGOs that focus on economic issues. They report that rental rates are climbing for the first time in recent memory.

¶5. (SBU) Several business contacts told PRToff that Baghdad residents are increasingly willing to pay the rent increases.

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For those willing to take the necessary security risks or to pay the asking price for property, goods and protection, Baghdad can be a very profitable place to do business. Walid Sharif, Executive Manager of the Small Business Development Center (SBDC) in Baghdad, told PRToff that the improved security conditions - which he largely attributes to the surge in Coalition Forces - have helped thousands of existing and new small businesses to resume or start activity in district markets and commercial centers throughout Baghdad. Sharif said he has also seen a marked increase in the number of participants in SBDC's classes on how to start small businesses and those taking advantage of USAID's Izdihar microfinance program to fund their business start-ups. The Coalition Forces' microgrant program has further contributed to this momentum, spurring small businesses to open in neighborhood markets across the province.

Banking Sector Antiquated

¶6. (SBU) Private and state-owned banks in Baghdad are antiquated and in desperate need of modernization. These banks and their respective branches cover the city, but they currently suffer from an uncertain security situation, scarcity of adequate capital markets, shortage of demand for value-added services, and a lack of transparency and accountability. Dictatorship, war and sanctions have isolated the banking sector from the benefits of updated international technology, standards, and business practices for approximately thirty years. Bank managers have little experience and limited opportunities to operate their banks as competitive entities, and do not offer essential products and services that current and potential customers require. The lack of a dependable electricity supply hinders internet reliability and prohibits routine banking operations, such as the transfer of electronic funds. The Central Bank of Iraq has taken steps to improve the overall banking regulatory climate and the Ministry of Finance has finally begun restructuring the state-owned banks Rafidain and Rashid, but

limited services, reduced capital bases, restricted customer reach, outdated technologies, and inadequately trained staff continue to hamper the banking industry. Even well-known international private banks such as HSBC (majority-owner of Baghdad-based Dar El-Salam bank), which have the capacity to perform banking functions at international standards, are waiting for the sector to improve dramatically before introducing extended service menus and commercial loan programs.

Sustainable Job Creation Lacking

¶7. (SBU) Small business development in any free market economy, but especially in Baghdad, is critical to sustainable private-sector led growth, with the potential to generate as much as two-thirds of all new jobs, according to the Center for International Private Enterprise (CIPE), an affiliate of the U.S. Chamber of Commerce. USAID's Community Stabilization Program is helping to fill the short-term job creation gap in critical areas in support of the Baghdad Security Plan. However, the GOI, provincial leadership and the private sector are only just beginning to comprehend the concepts of development in a market economy and the kind of economic analysis required to target sectors with the greatest potential for job creation in the short- and medium-terms. According to various members of local business associations, one of the key stumbling blocks to job creation in Baghdad is the inability of the GOI and the private sector to move citizens efficiently from educational institutions into the economy) from high school to either university, vocational training or military service, and then to the public or private sector. Many locals attribute this problem to GoI officials' broader inability to implement economic support initiatives, such as the Public Distribution System, and to a lack of technical experience in strategic planning, implementation, monitoring and evaluation of programs, such as the Ministry of Labor and Social Affairs micro-loan program. (COMMENT: The statements of many Iraqi citizens indicate that they do not differentiate between a facilitative role for the government in job creation, and a direct government role in providing long-term subsidies to businesses and placing people in private sector positions. END COMMENT.)

Civil Service Underperforming

¶8. (SBU) Iraqi business leaders and small business owners note that many, if not most, civil servants lack technical, administrative, financial and organizational skills. (NOTE:

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Many qualified civil servants have fled the country since ¶2003. END NOTE.) Anecdotal evidence indicates that the civil service is rife with nepotism, favoritism, and improvised hiring and firing practices. The most deficient areas include budget execution, essential service delivery, and support for private sector development. Although Baghdad has one of the best records in the country for budget execution, further improvement could significantly advance the reconstruction and development of infrastructure, such as roads and communication links, which businesses require to survive. Lack of access to essential services such as water and electricity prohibit many businesses from functioning effectively. These deficiencies will continue to slow economic growth in Baghdad unless GoI leaders and officials begin to improve the connection between Iraq's civil service and private sector growth.

Corruption Endemic

¶9. (C) Baghdad citizens frequently bemoan corruption among government officials at all levels. According to Transparency International's 2007 Corruption Perception Index, Iraq ranks last in the Middle East and 178 out of 180 countries worldwide. The chairman of one economic reform institute in Baghdad listed the government officials he would have to bribe to get the permits, property and goods necessary to start a business and keep it operating. In addition, he said that he would need to pay for security, to run a generator to keep lights on and equipment running, and to obtain fuel by waiting in long lines or purchasing it from the black market. According to Kamal Shabibi, Baghdad Provincial Council (PC) member and Chairman of the Economic Committee, corruption is deep-rooted in the province. He said that the PC has addressed the issue by establishing an Integrity Committee and adopting a code of ethics, to which all provincial employees must adhere. The Integrity Committee is empowered to investigate all allegations of fraud, abuse, waste and misconduct, up to and including the PC Chairman, Mayor and Governor. (NOTE: During a side conversation, the Integrity Committee Chairman suggested to PRToff that while by-laws grant the Committee this authority, a PC member would take great security and political risks by bringing charges against high-level officials. Such a course of action is simply unrealistic at this time, he implied. END NOTE.)

¶10. (C) While conceding that it is a first step, Shabibi believes that the PC has at last begun to address openly the fundamental principle of transparency. Shabibi added that he sees the oil sector as very vulnerable to corruption due to high profit margins, noting that the black market in Baghdad primarily survives on fuel. He said that he is aware of instances of oil products being smuggled into Iraq and resold by militias in Baghdad. The Provincial Council began this winter to play a major role in kerosene distribution throughout Baghdad, in a public attempt to undermine black marketeers and militias in Baghdad. (NOTE: PRT Baghdad will follow this initiative closely as many PC members have close ties to militias. The PRT is also involved in a USG inter-agency pilot project designed to support GoI efforts to counter militia influence on kerosene delivery in Baghdad. END NOTE.)

Early Efforts at Economic Reform

¶11. (SBU) GoI officials at the national and provincial levels have finally begun to institute economic reforms. They have passed an Investment Law which includes mechanisms for accountability, transparency and fee structures in the National Investment Commission and Provincial Investment Commissions. The 2007-2010 National Development Strategy reflects a more coordinated and forward-looking approach to economic development, as does the recent passage of the Provincial Development Strategy by the Baghdad Provincial Council (reftel). A new civil service law seeks to create a professional civil service that can more effectively carry out the functions of the state; the law requires officials to pass professional examinations to determine expertise and competency to carry out assigned functions. (NOTE: One effort by the Baghdad PRT aims to connect professional associations with civil servants, thereby creating a professional development mechanism to increase awareness and improve performance in both the private sector and government ministries. END NOTE.) On November 14, at the Baghdad Forum, government officials from all levels touted Baghdad's security gains, called for foreign investment, and emphasized the need to improve Baghdad's essential services and infrastructure.

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Doura Market Revival) Hope?

¶12. (C) The successful revival of commercial centers and markets in Baghdad - such as Doura market in Rashid district, Abu Nuwas Street in Rusafa district, and Haifa Street in Khark district - provide encouraging examples of how the Baghdad economy can thrive in the face of formidable challenges. Doura Market sits astride a fault line between Sunni, Shia and Christians in a heavily contested area of Rashid district. It contained 905 shops until 2006, when violence increased significantly and precipitated the closure of 895 shops. The 4/1 ID Brigade made reviving the market a major priority. The Brigade established a Combat Outpost (COP) in the market and Iraqi Police and Iraqi army units helped to provide security. The District Council established a Doura Market Committee which worked with the Brigade to develop and implement plans to clean out the market, operate a generator, build a fence, construct T-walls around the area, install street lights, paint store fronts, and place awnings on the shops. Store owners, initially reluctant to engage with the military and embedded PRT (E-PRT) officers, increasingly allowed them into their shops to discuss business ideas and microgrant assistance. As security increased, the market area began to stabilize. Doura Market now houses roughly 432 shops and operates for up to six hours a day. At the same time, other large and small market areas in Baghdad have recently begun to revive, most notably in the Karada peninsula, Adhamiya, Ameriya, and Ghazaliya.

Comment

¶13. (C) To advance the transition toward a stable market economy, the GOI must strengthen the capacity and integrity of their administrative, economic and legal infrastructures by building a professional civil service, addressing endemic corruption, advocating adherence to the rule of law, and improving links between educational institutions and the job market. Private sector leaders such as business owners, business associations, economic reform think-tanks and bankers have begun to pressure government officials to take steps toward reform. End Comment.
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